

Rates Spark: Fed holds, but ECB to keep cutting

The main outcome of the FOMC is a Fed somewhat constrained by inflation. It's a protective factor for Treasuries in the medium term, but not great for the here and now. Question: Has the Fed seen the PCE report? If yes, that's a worry! Thursday should see the ECB cut rates by 25bp, bringing the policy rate to 2.75%. We think the ECB will settle at 1.75% this summer, below market pricing. Together with the broader risk environment, we maintain a bullish stance on the short end of the euro swap curve



Treasuries eye issues with rate cut ambition, while QT end not made an issue just yet

It's clear that inflation is still an issue at the Fed. Not as severe as it was, but let's say, not a fully resolved issue. Treasuries have had the same view over recent months. This is a 3% inflation economy, and therein lies the genesis of the funds rate not getting back down to neutral (3%) and the 10yr Treasury yield remaining above 4.5%. The impulse reaction for Treasuries is negative due to this. We're not fully convinced this is the beginning of resumed bear market just yet, as we have

the PCE inflation report this week. The worry will be that the Fed has seen it, and maybe is not thrilled by it. If so, that's not great for Treasuries.

On the likely end to QT by mid year (our view), the short FOMC statement chose not to mention it. Maybe not big for them now. But they certainly must have talked about it. The issue here is excess liquidity (which we define as bank reserves plus reverse repo balances). It is likely to hit levels that the Fed would prefer not to go below from the middle of 2025 onwards, partly depending on how the debt ceiling saga evolves. The key number here is US\$3tn for bank reserves, representing about 10% of GDP. We are currently at US\$3.3tn. However, with QT running at US\$60bn per month, ongoing QT would bring reserves down in net terms. The Fed will want to end QT before things get overly tight.

But clearly the Fed did not want to make a big deal on the end of QT, as it will end. Rather the "no change" outcome is smothered by inflation stubbornness, although in the end smoothed over by another ever-calm Chair Powell performance.

We maintain a bullish view on 2Y swap rates going into the ECB meeting

Markets are fully pricing in a 25bp cut this meeting and also the next one in March is practically priced in. Thereafter the easing path is less clear and much hangs on the discussion of where the neutral rate sits and whether the ECB has to cut rates into accommodative territory. A survey conducted by Bloomberg shows a median expectation for the ECB to settle at 2%, which is broadly what markets are currently positioned for. In our view the ECB will cut to 1.75%, allowing for a slightly accommodative stance in the context of lingering growth risks.

When looking at the survey outcomes for 2026, around 25% of economists see the ECB cut to 1.5% or below, which signifies the downside risks to the rates outlook. We also take a more bullish view than current market pricing and think that any negative growth surprises can quickly push markets on a more dovish ECB rate trajectory. And whilst inflation may still cause some bumps on the road, we think growth will remain the key driver in the ECB's reaction function.

We don't expect the ECB to deviate from its broadly dovish message, but we will be listening for nuances in the balance of risks. If the risk of undershooting inflation is emphasised, then that would be a clear bullish signal for euro rates, with the 2Y swap rate potentially moving back lower towards 2.3%. Whilst instead a focus on near-term inflation risks, including higher energy prices, could move the 2Y rate in the opposite direction by some 10bp. Given the latest PMIs did not disappoint, we don't expect the growth narrative will have much market impact.

Thursday's events and market view

The ECB cutting by 25bp is seen as a near done deal, so all eyes will be on the Lagarde's press conference for any additional hints.

Data could turn out to be more market moving with the first estimates for fourth quarter growth both in the eurozone and the US out on Thursday. Eurozone data released ahead of the ECB meeting is likely to underscore a stagnant growth environment. This contrasts with the US where fourth quarter growth should come in close to 3%, boosted by a strong end to the year for consumer spending. The data should also allow for backing out monthly PCE figure ahead of the official release the next day. Other data to watch are the US jobless

claims.

In primary markets Italy is reopening 5Y, 10Y and 15Y bonds as well as 7Y floating rate notes for a total of up to €9bn.

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